UNIVERSITY OF LINCOLN

Best of the Blogs

Best of the Blogs collates the very best content from across the University of Lincoln's broad open blogging platform.

Find out more →

The etymology of sovereign crises and the

random walk

Dr Geeta Lakshmi, Senior Lecturer in Finance, Lincoln Business School: The last decade, it appears, has spawned a new generation of sovereign crises called the liquidity crises (for example in India, Asian Tigers, Russia and Turkey). These are quite different from debt crisis (such as those in Mexico, Indonesia and Sub Saharan Africa), where repayment is impossible […]

NOV 18, 2010

Dr Geeta Lakshmi, Senior Lecturer in Finance, Lincoln Business School:

The last decade, it appears, has spawned a new generation of sovereign crises called the liquidity crises (for example in India, Asian Tigers, Russia and Turkey). These are quite different from debt crisis (such as those in Mexico, Indonesia and Sub Saharan Africa), where repayment is impossible or near impossible. Unlike the chronic problems beset by debt crises, liquidity crises are maladies which can affect the rich and the comparatively well-heeled. They are characterised, as the name suggests, by lack of cash and can strike quite suddenly but are often cured by simple injections of cash given by a global agency or supranational under conditions and warranties. Debt crises on the other hand linger and painfully drag on.

This was the simple etymology of crises but a new type of crisis has now taken root. European countries find themselves centre stage of such malaise where liquidity is scarce but the problem will not go away so simply because of the change/shift in relative economic fundamentals. Thus it is not the country per se, which is poor; it is the perceived relative poverty which might linger due to cost-cutting and lack of demand. Overnight, countries which were once hotbeds of entrepreneurial activity, such as Ireland, find themselves succumbing to this. Thus bail out pressure and offers to help Ireland dominate the frontpages of the news and there is talk of an injection of 60 million Euros by the European Commission. Ireland is stalling taking on offers of help; these emanating from countries who are offering loans due to motives other than mere neighbourly concern. After all, countries in the euro-zone or major trading partners stand to lose out with the looming Irish crisis. It will take more time than a few hours to ascertain whether fundamentals have really changed or whether the crisis is economic risk led, i.e. change in relative fundamentals.
The current crisis has raised some very important issues about borrowers, currency of borrowing, global cushions and the fragility of the global system:

a) What is the benchmark yield if we are to compute credit spreads? Usually, to ascertain how risky a borrower was, one compared the borrower’s yield to a benchmark yield. The benchmark yield used to be the US Treasury for dollar issues. Typically, sovereign entities’ yields used to be lower than the corporate yields and were passed off as rock solid riskless yields, but this is no longer always the case.

b) The lack of confidence in sovereign yields is even more problematic now as the hegemony of power has shifted and the perceived value of currencies is no longer reflected in market values, the latter appearing to be artificially pegged. Thus which currency will carry the least risk as liquidity becomes an issue? Traditionally the Dollar was buoyed up and held Numero Uno position. That was despite the US being a chronic debtor for the last thirty years and because of the belief that the dollar would survive as its creditors were not consolidated. With China now holding vast reserves of the dollar and becoming a formidable singular adversary, liquidity is no longer guaranteed.
The markets, at the moment, do not trust any currency but are putting their bets on gold and commodities. Thus sovereign entities which hold reserves of either will be perceived to be rich as King Croesus in the Brave New World.

c) Who is the lender of the last resort as countries within the euro-zone are caught up in the North-South divide? (i.e. Germany insisting on the non bailout clause as Greece continues to be seen as still suffering from afflictions) Where will the global cushion come from and how long will it survive?

d) All bond valuation models focus on the prices of bonds being the summation of streams of future discounted cash flows. However the loans which are backed by the bonds need to be seen as generating activity which gives rise to these positive cash flows. If the activities are not seen to be productive or long term value creating, bond prices will fall. Although governments are cutting budgets and the market has initially welcomed this step, it remains to be seen whether the cutbacks are visualised, in the longer run, to be cleaning up of wasteful expenditure or whether they will leave behind a stricken, crippled economy caught up in the bloodbath of ruthless cost cutting.

As a financial economist it is fascinating to watch the events which are unfolding. These are interesting times and I wish we had a crystal ball to let the world know which wind will make which chaff fall which particular way. There is however, the concept of random walk which is at the heart of financial theory and posits that evolution of prices (yields) cannot be predicted perfectly in the long run. It is certainly holding its own place right now.